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By email only:

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Tēnā koe Jonathan

Vector's sale and leaseback transactions: warning letter for non-compliance with DPP3 and information disclosure requirements for years ended 2020 and 2021

Purpose

1. The purpose of this letter is to advise you of our enforcement decision for Vector Limited's (**Vector**) likely contraventions of the:
 - 1.1 Electricity Distribution Information Disclosure Determination 2012 (**ID Determination**)¹ for the disclosure years ended 31 March 2020 and 2021; and
 - 1.2 Default Price-Quality Path Determination 2020 (**DPP3**)² for the assessment period (**AP**) beginning 1 April 2021.
2. The Commission has decided to issue a warning letter to Vector for its conduct related to the sale and leaseback transactions dated 31 March 2020.

Vector's conduct

3. On 31 March 2020, Vector sold a CBD tunnel and a portfolio of substation land and buildings to two subsidiaries, wholly owned by Vector.³ On the same date, the

¹ Electricity Distribution Information Disclosure Determination 2012 [2012] NZCC 22 (as amended).

² Electricity Distribution Services Default Price-Quality Path Determination 2020 [2019] NZCC 21 (as amended).

³ Vector Auckland Property Limited and Vector Northern Property Limited. See Vector Limited *Electricity Distribution Information Disclosure for Related Party Transactions for year ended 31 March 2020*,

subsidiaries leased the right to use those assets back to Vector, to be used in the supply of electricity lines services (**Transactions**).

4. As a result of the regulatory treatment of the Transactions, Vector disclosed an increased regulatory asset base (**RAB**) of approximately \$300m in relation to the Transactions in its related party transactions information disclosures for the year ended 31 March 2020.⁴
5. Vector's regulatory disclosures in respect of the Transactions were made in reliance upon an interpretation of the Electricity Distribution Services Input Methodologies Determination 2012 (**EDB IMs**)⁵ that the Commission considers incorrect and contrary to the purpose of Part 4 of the Commerce Act 1986 (**Commerce Act**).
6. The Commission identified the increased RAB in our review of Vector's information disclosures and initiated an investigation into potential contraventions related to the Transactions on 16 December 2020.
7. From this date, the Commission exchanged correspondence with Vector. On 5 August 2022, as a result of the correspondence, Vector agreed to reverse its historic and future regulatory treatment of the Transactions.

Vector reversed its incorrect regulatory treatment of the Transactions

8. On 3 October 2022, Vector published revised disclosures, assurance reports and directors' certificates, demonstrating the reversal of its incorrect regulatory treatment of the Transactions.⁶
9. Vector maintains that its interpretation of the input methodologies was correct but nonetheless reversed its regulatory treatment of the Transactions.
10. The Commission is satisfied that the steps taken by Vector to reverse the supplier's regulatory treatment of the Transactions, and the associated revised disclosures, meet the Commission's enforcement aims. This reversal of Vector's incorrect treatment of the Transactions promotes the purpose of Part 4 of the Commerce Act

available at <https://www.vector.co.nz/about-us/regulatory/disclosures-electricity/financial-and-network-information>.

⁴ Vector Limited Electricity Distribution Information Disclosure for Related Party Transactions for Year End 31 March 2020 (available at <https://www.vector.co.nz/about-us/regulatory/disclosures-electricity/financial-and-network-information>) and *EDB Information Disclosures for year ended 31 March 2020* at Schedule 4.

⁵ Commerce Commission *Electricity Distribution Services Input Methodologies Determination 2012* (as amended) [2012] NZCC 26, available at https://comcom.govt.nz/_data/assets/pdf_file/0017/60542/Electricity-distribution-services-input-methodologies-determination-2012-consolidated-20-May-2020-20-May-2020.pdf.

⁶ The revised disclosures are available online at <https://www.vector.co.nz/about-us/regulatory/disclosures-electricity/financial-and-network-information> and <https://www.vector.co.nz/about-us/regulatory/disclosures-electricity/price-quality-path>).

by preventing the potential for Vector to charge consumers higher prices without providing a corresponding benefit.

11. The Commission acknowledges Vector's cooperation with our investigation and its constructive approach towards engagement with us, ultimately resulting in the reversal of its regulatory treatment of the Transactions.

Potential harm to consumers

12. In its revised disclosures, Vector describes the purpose of the Transactions as follows:⁷

The Transactions were undertaken to separate Vector's land and buildings into separate subsidiaries, accountabilities and reporting lines, to commercialise, develop and realise additional revenue from these assets outside the regulated business, and to create opportunities for future capital raising to support our ongoing investment in Auckland growth and electrification to enable net zero 2050.

13. Had Vector's regulatory treatment of the Transactions not been reversed, it would have caused Vector to significantly overcharge consumers, without any substantive change to Vector's assets or the services provided using those assets.
14. The Commission's primary enforcement aim is to prevent consumers suffering harm through higher prices due to Vector's increased RAB. If Vector's regulatory treatment of the Transactions was not reversed, we estimate this would have resulted in consumers being significantly overcharged for regulated services provided using the same assets. This represents an unjustified additional cost without any corresponding service quality or other benefit to consumers.

Regulatory background

15. Suppliers of electricity distribution services (**EDBs**) are subject to regulation under Part 4 of the Commerce Act 1986 (**Commerce Act**). Vector is subject to:

15.1 information disclosure (**ID**) regulation,⁸ and

15.2 default price-quality (**PQ**) regulation.⁹

The Regulatory Asset Base (RAB)

16. The RAB is a key input in the building-blocks model of regulation used to determine the revenue that EDBs are allowed to recover for the supply of regulated services under Part 4 of the Commerce Act. It is the main component of the value of the assets used to calculate both the return of and return on capital (depreciation and

⁷ The revised disclosures are available online at <https://www.vector.co.nz/about-us/regulatory/disclosures-electricity/financial-and-network-information> and <https://www.vector.co.nz/about-us/regulatory/disclosures-electricity/price-quality-path>).

⁸ Subpart 4, Part 4 Commerce Act 1986.

⁹ Subpart 6, Part 4 Commerce Act 1986. Vector is a non-exempt EDB.

cost of debt and equity capital). It is fundamental to regulation under Part 4 of the Commerce Act that RAB values are properly determined through regulatory mechanisms in the input methodologies, set by the Commission as regulator. As a general principle, a higher RAB allows an EDB to earn greater revenues and the opportunity to earn greater profits.

Input methodologies

17. Vector must correctly apply the requirements of the EDB IMs in order to comply with its obligations under the ID Determination and DPP3.
18. Subpart 2 of the EDB IMs sets out the requirements for valuing assets for the purpose of ID and PQ regulation.
19. Under clause 2.2.11 of the EDB IMs, Vector is required to value assets commissioned in related party transactions in accordance with generally accepted accounting practice (**GAAP**), except to the extent that the resulting valuation exceeds the actual cost incurred or the cost that would be incurred for the same asset in an arm's length transaction.¹⁰ In an arm's length transaction, GAAP requires leased 'right of use' assets to be valued at a lesser proportion of the carrying value of the ownership assets,¹¹ before they were sold.

Information disclosure regulation

20. Vector is subject to ID regulation requiring it to publicly disclose certain information to allow interested persons, including the Commission, to assess whether the purpose of Part 4 is being met.¹²
21. Under section 86(1) of the Commerce Act, a contravention of an ID requirement may attract a pecuniary penalty not exceeding \$5m. Section 86(2) provides that an EDB contravenes an ID requirement where it fails to disclose information required to be disclosed, fails to disclose information in the form or within the time required, or discloses information that is false or misleading.

Price-quality regulation

22. Vector is subject to PQ regulation, which sets the maximum revenues an EDB may earn over a regulatory period and includes quality standards and incentives for an EDB to maintain or improve the quality of its supply of electricity lines services.¹³

¹⁰ The relevant rule under generally accepted accounting principles (GAAP) is NZ IFRS 16 *Leases*, available at <https://www.xrb.govt.nz/standards/accounting-standards/for-profit-standards/standards-list/nz-ifs-16/>.

¹¹ That is the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee: NZ IFRS 16 at [100].

¹² This includes disclosures of Vector's related party transactions and regulatory asset base (rolled forward) as set out in clause 2.3.1 of the ID Determination.

¹³ Vector was subject to the Electricity Distribution Services Default Price-Quality Path Determination 2015 [2014] NZCC 33 (**DPP2**) on 31 March 2020 and DPP3 from 1 April 2020.

23. Price-quality regulation under DPP3 requires Vector to publish annual compliance statements setting out certain financial information demonstrating compliance with the applicable price-quality path and quality standards.
24. Under section 87(1) of the Commerce Act, a contravention of a PQ requirement may attract a pecuniary penalty of \$5m. Section 87(2) provides that an EDB contravenes a PQ requirement where it fails to comply with the requirements for prices, whether by charging a price for the goods or services that is higher than the maximum price permitted, or by receiving more revenue than is permitted, or in any other way.

Summary of compliance issues

25. Vector increased its RAB by approximately \$300m in its regulatory disclosures because of its incorrect regulatory treatment of the Transactions. We consider this led Vector to contravene the ID and PQ requirements set out above.
26. In our view, Vector's interpretation of the EDB IMs is contrary to the long-standing principle that revaluations, for the purpose of determining profitability, ought to be treated as income.
27. The Commission considers Vector's conduct amounts to a contravention of its ID requirements for the years ended 31 March 2020 and 2021. Vector disclosed system growth asset values and RAB values in reliance upon an interpretation of clause 2.2.11 of the EDB IMs that the Commission considers incorrect and contrary to the purpose of Part 4 of the Commerce Act. Therefore, those values did not represent the correct regulatory value of the assets. As a result, Vector failed to disclose information that it was required to disclose or disclosed false or misleading information.¹⁴
28. The Commission considers Vector's conduct amounts to a contravention of its PQ requirements for DPP3 by disclosing a forecast allowable revenue value that was higher than it should have been in its price-setting compliance statement for the year beginning 1 April 2021. This value was disclosed in reliance upon the misinterpretation of clause 2.2.11 of the EDB IMs, contrary to the purpose of Part 4 of the Commerce Act. Therefore, the forecast allowable revenue value did not represent the true regulatory position and Vector failed to comply with its requirements for prices.¹⁵
29. During the Commission's investigation into the Transactions, Vector twice deferred passing the costs of the increased RAB through to consumers. Subsequently, Vector decided to reverse its regulatory treatment of the Transactions. Because of this reversal, Vector did not actually overcharge any consumers.

¹⁴ Commerce Act 1986, section 86(2)(a) and (c).

¹⁵ Commerce Act 1986, section 87(2)(b)(i).

Enforcement decision

30. Vector considers that a warning letter is disproportionate to the relevant conduct and a compliance advice letter would be the most appropriate enforcement response. This is because Vector considers that its interpretation of the EDB IMs reasonably differs from that of the Commission. Further, in Vector's view, compliance advice would be most consistent with the Commission's existing enforcement practice.
31. If Vector had not reversed its regulatory treatment of the Transactions, it would have been necessary for the Commission to bring Court proceedings to prevent harm to consumers and deter similar conduct by Vector and other regulated suppliers.
32. The Commission has decided to issue a warning letter to Vector for the ID and PQ contraventions. We consider this is the appropriate enforcement response, given Vector's serious and intentional conduct, mitigated by its decision to reverse its regulatory treatment of the Transactions.
33. Under sections 86 and 87 of the Commerce Act, the Court may order an EDB to pay a pecuniary penalty if it is satisfied that the EDB has contravened an ID or PQ requirement. In making this decision, the Commission has exercised its enforcement discretion and decided not to issue High Court proceedings seeking an order that Vector pay a pecuniary penalty for its conduct.

Enforcement criteria

34. In reaching our enforcement decision, we assessed Vector's conduct against our enforcement criteria:¹⁶
 - 34.1 extent of detriment;
 - 34.2 seriousness of conduct; and
 - 34.3 public interest.
35. Because Vector has reversed its incorrect regulatory treatment of the Transactions, the Commission has achieved its primary objective of preventing harm to consumers. Therefore, the public interest in a higher-level enforcement response to the contraventions is reduced.

Aggravating factors

36. We consider the principal aggravating factors of Vector's conduct are as follows:
 - 36.1 The contraventions occurred as a result of deliberate decision-making by Vector to incorporate a regulatory treatment of the Transactions into its

¹⁶ <https://comcom.govt.nz/about-us/our-policies-and-guidelines/investigations-and-enforcement/enforcement-criteria>.

regulatory disclosures, based on an interpretation of the EDB IMs that the Commission considers is incorrect.

- 36.2 The revaluation gain related to the Transactions was large. If Vector had not reversed its regulatory treatment of the Transactions, its conduct would have resulted in significant harm to consumers through excess revenues.
- 36.3 That harm was prevented only because of the Commission's intervention. By including the increased RAB in its information disclosures and price setting compliance statement, Vector was engaged in a course of conduct to incorporate its regulatory treatment of the Transactions into its prices.
- 36.4 Vector presented the Transactions and their commercial rationale to the Commission in October 2020, after the Transactions had taken place, but did not explain its intended regulatory treatment.

Mitigating factors

- 37. However, in the Commission's view, Vector's conduct is mitigated by the following factors:
 - 37.1 Vector co-operated with the Commission's investigation into the Transactions.
 - 37.2 At all available opportunities, Vector chose not to include its treatment of the Transactions in its pricing decisions. This prevented unnecessary harm to consumers on an interim basis.
 - 37.3 Vector's ultimate decision to reverse its regulatory treatment of the Transactions prevented the potential for harm to consumers on a final basis.
 - 37.4 Further, Vector's reversal meant the Commission was not required to go to the expense of court proceedings to seek remedies preventing harm or otherwise enforce Vector's regulatory requirements and deter similar conduct.

Future expectations of regulated suppliers

- 38. In this case, Vector transferred ownership of assets to wholly-owned subsidiaries and leased those assets back, creating 'right of use' assets. Its application of the asset valuation EDB IM in these Transactions to the 'right of use' assets resulted in a large revaluation gain with respect to the previous regulatory book value of the physical assets. This created an artificial increase in the value of the RAB which could have resulted in increased revenue recovery from consumers, without any corresponding improvement in service quality or other benefit.
- 39. This treatment is contrary to the IMs and the purpose of Part 4 of the Commerce Act.

40. This letter warns Vector and all regulated suppliers about undertaking similar valuation methodologies in reliance upon a similar interpretation of the IMs that is contrary to the Part 4 purpose.
41. If any regulated supplier is contemplating a significant revaluation or restructuring of its assets, we strongly encourage early engagement with the Commission. In order to prevent the need for an enforcement response, regulated suppliers are advised to engage with the Commission within a reasonable period of time before the execution of any significant transaction.
42. If Vector engages in similar conduct in the future, the Commission retains the ability to open further investigations into the conduct.

Further information

43. This letter warns Vector for conduct the Commission considers is likely to amount to contraventions of the applicable ID and PQ requirements. However, it is important to note that only the Courts can determine whether Vector's conduct amounts to a contravention of the ID Determination and DPP3.
44. This letter is public information and will be published on our website. We may also make public comment about our investigations and conclusions.
45. Thank you for your co-operation with this investigation. Please contact Robert Cahn, Chief Legal Counsel – Infrastructure Regulation at [REDACTED] if you would like to discuss this letter.

Yours sincerely

[REDACTED]

Sue Begg
Deputy Chair